

Piper Rudnick

MEMORANDUM

To: John A. Picciotto
From: R.W. Smith, Jr.
William Taylor IV
Date: April 22, 2002
Subject: Piper Rudnick Advice to Board of Directors

We have served as legal counsel to CareFirst, Inc., a Maryland non-profit health service plan ("*CareFirst*"), and CareFirst of Maryland, Inc., a Maryland non-profit health service plan ("*CFMD*"), in connection with the proposed conversion of each of CareFirst and CFMD to a for-profit entity and the concurrent acquisition of CareFirst by WellPoint Health Networks Inc. ("*WellPoint*") pursuant to the Agreement and Plan of Merger dated November 20, 2001, by and among CareFirst, WellPoint and Congress Acquisition Corp. ("*Merger Sub*"). CareFirst is the sole member of CFMD. Merger Sub is a wholly-owned subsidiary of WellPoint and was formed for the purpose of effecting the acquisition of CareFirst.

In considering the proposed conversion and potential acquisition, the CareFirst Board of Directors analyzed the consequences of a conversion to a for-profit entity and the terms of proposed acquisitions of CareFirst by several potential acquirers. In order for the CareFirst directors to fulfill their obligations and to facilitate their analysis of the proposed conversion and acquisition, the CareFirst Board of Directors solicited and received advice from various experts regarding the financial, legal and accounting aspects of the matter. We provided the CareFirst Board of Directors legal advice regarding the duties of its directors pertaining to the proposed acquisition (including advice with regard to the process and information necessary to fulfill such duties), the material terms of the proposed merger agreements with the potential acquirers and the appropriateness of considering certain acquirers during certain stages of the process.

In connection with a supplemental filing with the Maryland Insurance Administration ("*MIA*") regarding the proposed conversion and the concurrent acquisition of CareFirst by WellPoint in connection therewith, we have been asked to provide the MIA with a chronology of the advice that we rendered to CareFirst's Board of Directors regarding its legal obligations in considering such acquisition. During the course of the negotiations between CareFirst and the potential acquirers, we provided both formal and informal legal advice to the CareFirst directors and management. We

6225 Smith Avenue • Baltimore, Maryland 21209-3600 •

Piper Rudnick LLP and related entities including an Illinois General Partnership

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regularly attended meetings of the CareFirst Board of Directors and its committees in order to be available to provide legal advice. At some of the meetings we generally responded to inquiries made by the directors, while at other meetings we made a formal presentation regarding the duties and obligations of the CareFirst directors and the terms of the transactions with the potential acquirers. The following provides a chronology and a brief description of the formal advice that we provided to the CareFirst directors.

January 22, 2001 Elizabeth Grieb, a partner at our firm, attended a meeting of the Strategic Planning Committee of the Board of Directors of CareFirst. Ms. Grieb discussed the duties of the CareFirst directors in connection with a possible business combination. Attached hereto as Exhibit A is a copy of the memorandum dated January 16, 2001, that we provided to the Strategic Planning Committee in connection with its meeting.

February 22, 2001 Ms. Grieb attended a meeting of the Board of Directors of CareFirst and discussed the duties of the CareFirst directors in connection with a possible business combination. A copy of our memorandum dated January 16, 2001 was provided to all of the directors.

April 26, 2001 R.W. Smith, Jr., a partner at our firm, attended a meeting of the Strategic Planning Committee of the Board of Directors of CareFirst and a meeting of the Board of Directors of CareFirst. At each such meeting, Mr. Smith discussed the material terms of the proposed acquisition of CareFirst and commented on the duties and responsibilities of the directors of CareFirst.

July 25, 2001 Mr. Smith attended a meeting of the Strategic Planning Committee of the Board of Directors of CareFirst and a meeting of the Board of Directors of CareFirst. At each such meeting, Mr. Smith discussed the material terms of the proposed acquisition of CareFirst and commented on the duties and responsibilities of the directors of CareFirst.

November 20, 2001 Mr. Smith attended a meeting of the Strategic Planning Committee of the Board of Directors of CareFirst and a meeting of the Board of Directors of CareFirst. At each such meeting, Mr. Smith provided an analysis of the CareFirst directors' duties in connection with an acquisition of CareFirst by WellPoint. Further, in response to an inquiry from a director, Mr. Smith advised the CareFirst Board of Directors that it was not inconsistent with the Board's exercise of its duties for it to chose not to explore a transaction with Anthem Inc. at that time and to approve the transaction with WellPoint. Attached hereto as Exhibit B is a copy of the memorandum dated November 30, 2001, that we provided to the Boards of Directors of each of CareFirst, CFMD, Group Hospitalization and Medical Services, Inc. and BCBSD, Inc., which memorandum describes the advice given by our firm at such above-referenced meetings.

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Exhibit A

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MEMORANDUM

To: John A. Picciotto
From: Piper Marbury Rudnick & Wolfe
Date: January 16, 2001
Subject: Fiduciary Duties of Directors in connection with possible business combination

Blue Cross and Blue Shield plans are rapidly merging with one another and converting to for-profit status. There are now approximately 50 Blue Cross and Blue Shield plans in the United States, although that number is continuing to shrink. Since 1994, five plans have converted or are trying to convert to for-profit status, 47 run for-profit subsidiaries, and 30 are merging with other plans.

This memorandum addresses the fiduciary duty issues involved in connection with a possible transaction between CareFirst and another Blue Cross and Blue Shield plan. After a discussion of fiduciary duties in general and some relevant case law, we will highlight relevant statutes from the affected jurisdictions and discuss the fiduciary duty issues raised by those statutes. In Part II we will discuss additional case law bearing on the approach taken by Attorneys General in regulating nonprofit entities and the implications this has on defining a director's duties. While the case law covers judicial decisions from a variety of states, the statutory discussion involves only the laws of the jurisdictions in which CareFirst and its subsidiaries are licensed to do business: the States of Maryland and Delaware, the District of Columbia and the Commonwealth of Virginia.

I. Fiduciary Duties in General

In general, the guiding principle of fiduciary duty is that directors must act in good faith, with the reasonable belief that their acts are in the best interest of the corporation, and with the care that an ordinarily prudent person would use under similar circumstances. There is a rebuttable presumption that director action complies with this standard. This general statement of fiduciary duty can be broken down into the Board's general oversight responsibilities and into the duties of care and loyalty/fidelity owed by the Board.



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A. General Oversight Responsibilities

Under Maryland, Delaware, District of Columbia and Virginia law, the business and affairs of a corporation shall be managed by or under the direction of a board of directors.¹ This oversight role of the board includes (i) approving operating, financial and other corporate plans and strategies, (ii) evaluating the performance of the corporation, (iii) selecting, evaluating and fixing compensation for senior management of the corporation, and (iv) adopting policies of corporate conduct and practice to provide for compliance with laws, orders and regulations, for provision of financial and operation information to the board and senior management and for maintenance of accounting and other internal controls.

B. Duties

The basic duties of the directors of a corporation generally include a duty of care and a duty of loyalty.

1. Duty of Care

The duty of care requires a director to be diligent and prudent in managing the corporation's affairs and to discharge his/her duties on an informed basis with due care. A director must inform himself of all material information reasonably available to him before making a business decision.² Once informed, a director must act with requisite care in discharging his/her duties. The level of care required rises with the significance of the decision being made.

¹See 8 Del. Code Ann., Gen. Corp. Law, § 141(a) (2000); D.C. Code § 29-332 (2000); Md. Code Ann., Corps. & Ass'ns, § 2-401 (2000); Va. Stat. Ann. §13.1-673 (2000).

² See Notes/Annotations to 8 Del Code Ann., Gen. Corp. Law, § 141 (discussing the duty of care under Delaware case law); Md. Code Ann., Corps. & Ass'ns., § 2-405.1(a)(setting forth the Md requirements that a director perform his/her duties (1) in good faith, (2) in a manner he or she reasonably believes to be in the best interest of the corporation, and (3) with the care that an ordinarily prudent person in a like position would use under similar circumstances); Va. Stat. Ann. § 13.1-690 and the accompanying notes/annotations. Neither the D.C. Code nor D.C. case law contains any direct references to the duty of care. The only case law in D.C. that mentions it involves cases where the courts are interpreting the law of other states.



In the context of a possible merger of the company, the duty of care would require a director to regularly attend and participate in meetings, review and contribute to meeting agendas, timely request and review sufficient information to be properly informed about the merger and make responsible inquiry when circumstances warrant. Each director should exercise his or her independent judgment on all corporate decisions.

a. Reliance on information from others

A director may rely on information and reports from (i) an officer or employee whom the director reasonably believes to be reliable and competent in the matters presented, (ii) a lawyer, public accountant or other person, as to matters which the director reasonably believes to be within the person's professional or expert competence, and (iii) a committee of the board on which the director does not serve as to a matter within its designated authority, if the director reasonably believes the committee to merit confidence.³ However a director may not rely on such information or reports if the director has knowledge that would make such reliance unreasonable.⁴

Note that directors may not avoid active and direct oversight duties by relying on others on significant matters, including a merger or other sale or corporate control. A director relying on others should exercise diligence to ensure that such reliance is reasonable by keeping informed of the efforts of those to whom work has been delegated. For example, a director who is not a member of a committee cannot simply rely upon the existence of the committee to satisfy his or her duty of care.⁵

b. Business Judgment Rule

The Business Judgment Rule protects directors who exercise good faith judgment from liability arising from an unwise or unsuccessful corporate action resulting from a

³8 Del. Code Ann. §141(e)

⁴ Md. Code Ann. Corps. & Ass'ns §2-411(d).

⁵ The standard is somewhat more strict in D.C. where D.C. Code §29-337 allows the Board to create committees and delegate powers thereto but such delegation does not relieve the Board of any responsibility imposed by law. Moreover, the D.C. Statute does not explicitly permit reliance on the opinion of experts such as lawyers or public accountants.

decision of the directors. It insulates these decisions from judicial review, absent fraud, illegality or bad faith, as long as the director exercised informed business judgment. Willful blindness is not acceptable, however. The Delaware Supreme Court in *Smith v. Van Gorkom*⁶ stated that the Business Judgment Rule does not protect directors who breach their duty of care by not making informed decisions.

2. Duty of Loyalty/Fidelity

A director must exercise his or her powers in the best interest of the corporation and not in the director's personal interest or in the interest of another person.⁷ The director should not use a corporate position for personal gain at the expense of the corporation. The duty of loyalty arises in various situations⁸ to prohibit forms of self-dealing and misappropriation of corporate assets. For example, in *Nixon v. Lichtenstein*,⁹ the attorney general sued and removed two directors who breached their fiduciary duties by causing the corporation to pay their personal obligations. The fiduciary standard is even higher when significant business decisions, such as a conversion or merger, are involved.

The Delaware Supreme Court has concluded in two leading cases that directors have special obligations in the sale/merger of a corporation.¹⁰ In this context, directors must act reasonably to find the best offer available to the company. In deciding if the directors have acted reasonably, courts will look at how the directors have come to their decision,

⁶ 488 A. 2d 859 (Del. 1985).

⁷ See notes/annotations accompanying 8 Del. Code Ann. §141; Md. Code Ann. §2-419; Va. Stat. Ann. 13.1-694 (discussing Virginia's duty of fidelity). The D.C. Code contains no direct references to the duty of loyalty, but see *Wisconsin Ave. Associates, Inc. v. 2720 Wisconsin Ave. Co-op*, 441 A. 2d 956 (D.C., 1982) (discussing directors' fiduciary duties to the corporation including the duty of loyalty).

⁸ For example, in situations involving interested director transactions, interlocking boards, corporate opportunity and confidentiality.

⁹ 959 S.W. 2d 854 (Missouri Court of Appeals, 1997).

¹⁰ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173 (Del. 1986); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A. 2d 34 (Del. 1994).

and whether that decision is reasonable in the context of those circumstances. The process followed in making the decision must be fair and the price obtained for the corporation must also be fair. In this context, Delaware courts have applied a more rigorous standard than the Business Judgment Rule, mentioned in the previous section, to the sale of a corporation. If the more rigorous standard applies, courts not only look to see if the board of directors used due care in preparing itself to make decisions and whether the decisions were tainted by self-dealing, but also determine whether the board's decisions were reasonably calculated to achieve a legitimate corporate objective.

The leading case in which this heightened standard was applied was *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). When the *Revlon* standard applies, the board of directors is required to obtain the best possible price for the shareholders, and many factors that a board ordinarily is permitted to consider (e.g. the interests of employees, customers or the communities in which the corporation does business) can no longer properly be taken into account. However, *Revlon* primarily applies to situations where there has been a "change in control", i.e., when the shareholders are losing, once and for all, their opportunity to obtain a control premium. For example, *Revlon* does not apply to a board of directors' decision to enter into a stock-for-stock merger in which the shareholders of their corporation will continue as full equity participants in the ongoing post-merger venture.¹¹

Since any possible transaction between CareFirst and another Blue Cross Blue Shield Plan would involve a stock-for-stock merger or share exchange, it is unlikely that a court would conclude that *Revlon* would apply to the merger. Two cases have applied the heightened *Revlon* standard to stock-for-stock mergers¹² where it would not otherwise apply, but only because deal protective measures such as "no shop" provisions in the cases were so restrictive that they limited the ability of the directors to fulfill their fiduciary duties by considering better offers. Other cases, decided both before and after *Phelps* and *ACE*, applied the Business Judgment Rule, and not the heightened *Revlon*

¹¹ See generally *Paramount Communications, Inc. v. AVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

¹² See *Phelps Dodge Corp. v. Cyprus Amax Minerals Co., C.A. No. 17398* (Del. Ch. Sep. 27, 1999); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999). Both cases suggested that, at least under certain circumstances, "no shop" provisions that are so strict that they prevent the board of directors from speaking to other potential bidders may be invalid, even in connection with transactions that do not constitute changes in control.



standard, to deal protection measures contained in agreements for stock-for-stock mergers and suggested that such provisions were valid, even those containing "no-shop" provisions that prevent the board of directors from speaking to other potential bidders.¹³ Thus, as long as CareFirst does not enter into any overly restrictive deal protection measures¹⁴ that may try to limit the fiduciary duties owed by the directors, it appears that the Business Judgment Rule, and not the heightened *Revlon* standard, would apply to a possible CareFirst transaction.

Further evidence that the *Revlon* standards would not apply to a CareFirst transaction is the fact that to date, no court has applied *Revlon* to the board of directors of a not-for profit, either in the context of a conversion or a merger. Although some commentators have tried to make the case that *Revlon* should apply to not-for-profit boards¹⁵, the CareFirst board may rely on the fact that no court has adopted this view.

As mentioned above, in a context where *Revlon* duties are applicable, a board of directors must abandon consideration of non-price factors in favor of obtaining the best price for the corporation's shareholders. In a context where *Revlon* does not apply, non-price factors may be considered by the board in the exercise of its business judgment as part of the process of determining whether a particular offer is in the best interest of the corporation.

¹³ See G. Varallo & S. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 BUS. LAW. 1609, 16198-35 (2000).

¹⁴ See *ACE*, 747 A.2d at 107 (citing *Paramount Communications Inc. v QVC Networks Inc.*, 637 A.2d 34 (Del. Supr. 1994)). The court noted that QVC does not say that a board can, in all circumstances, continue to support a merger agreement not involving a change in control when: 1) the board negotiated a merger agreement that was tied to voting agreements ensuring consummation if the board does not terminate the agreement; 2) the board no longer believes that the merger is a good transaction for the stockholders; and 3) the board believes that another available transaction is more favorable to the stockholders. The fact that the board has no *Revlon* duties does not mean that it can contractually bind itself to sit idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about. *Id.*

¹⁵ See Colin Moran, *Why Revlon Applies to Nonprofit Corporations*, 33 BUS. LAW. 373 (1998) (arguing that state law already presupposes that *Revlon* duties apply to nonprofit boards and that *Revlon* duties would redress the problem of self-dealing in the nonprofit context as well as they did in the for-profit context).